No. 12,530

IN THE

United States Court of Appeals

For the Ninth Circuit

NICK W. MAROOSIS,
Appellant,

vs.

JAMES G. SMYTH, United States Collector of Internal Revenue,
Appellee.

On appeal from the United States District Court for the Northern District of California, Southern Division.

APPELLANT'S REPLY BRIEF.

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APPELLANT'S REPLY BRIEF.

APPELLANT'S STATEMENT OF FACTS IS ACCEPTED BY APPELLEE.

Since appellee did not challenge the statement of the case made in appellant's brief, that statement is apparently acceptable.

THE CORRECTNESS OF THE 96% FIGURE HAS BEEN ESTABLISHED BY APPELLANT AND HAS NOT BEEN DISPROVED BY APPELLEE AND NO UNDERPAYMENT OF TAX EXISTS.

The primary assessment in this case was based upon a formula, in which the only figure in dispute is the percentage of distilled spirit sales during the period

in question. *Although the major issue* in this case is whether the 86% or 96% figure is the correct one in the formula, *only one paragraph* in the brief for appellee (pp. 15-16) is directed to that point. If the 96.41% figure is correct, no under-declaration of inventory by appellant exists. In the absence of an under-declaration, we find appellee attempting to prove an act was done with a fraudulent intent by attempting to prove the intent without proving the act.

Appendix A of brief for appellant sets forth each figure used by the State Board in determining the 96.41% figure. Appendix A traces each figure in the State audit to the books and records of appellant in evidence. *Appellee's brief is silent on this point.*

Appellant's brief cited the testimony of J. Bruck, C.P.A., wherein he set forth the method used by the State Board to reach the figure of 96.41%, and that his own check showed the correctness of said audit. (Tr. p. 172; Brief for Appellant, p. 19.) *Appellee's brief is silent on this point.*

Appellee's only objection at the trial to the State audit was that it did not determine sales at ceiling prices. (Tr. pp. 268, 269; Brief for Appellant, p. 18.)

Appellant's brief pointed out explicitly how the State audit determined distilled spirit sales at ceiling prices (Brief for Appellant, p. 21) and that alleged over-ceiling sales were neither founded on the evidence nor were they material to this case. (Brief for

Appellant, pp. 34-36.) *Appellee's brief is silent on this point.*

It is truly significant that appellee failed to dispute one single figure in the State Board audit.

Furthermore, by complete silence on the alleged over-ceiling sales, appellee has evidently *completely abandoned its only objection on the trial to the 96.41% figure.*

Not one single factual reference is cited by appellee to support the 86% figure. Appellee is satisfied to let his argument rest with: "Thus the determination of the Commissioner was made upon the taxpayer's own estimate. Wherein then is it arbitrary?" (Br. for Appellee, p. 17.)

It is wrong basically because where actual figures exist, estimates are pure guesses. Appellant has answered this question fully in his brief. (Brief for Appellant, pp. 13-28, 39-42; Appendix A.) Appellee has not even attempted to answer those arguments.

Failing to support the 86% figure, appellee set forth six defenses to the 96% figure:

I. "Taxpayer has failed to attack the correctness of the formula used except to say that instead of using 86% the agent should have used 96% because that is the per cent used by the State auditor to determine the quantity of distilled spirits in proportion to the gross sales." (Brief for Appellee, p. 15.)

That statement is wholly incorrect. Nowhere does appellant so contend. Appellant *never urged* the use

of 96% because "that is the per cent used by the State Auditor." Appellant urged the use of the 96% figure because the State Auditor determined that it was the *correct* percentage of distilled spirits sold. It was arrived at by actual audit—not by "estimates" or by guesswork. Appendix A of brief for appellants is indisputable.

The purchase figures and the gross sales figures in the formula were taken from the records of the taxpayer. The conversion into proof gallons is simple arithmetic. The only figure in the formula open to question was the 86%. Every figure in the State audit was derived from the books and records of the appellant and the 96 per cent determination can be made from the records in evidence independent of the State Board audit. (See Appendix A, Brief for Appellant.)

II. "The period of time involved in the State Auditor's calculation was from July 1, 1943, to June 30, 1944; only three quarters of which cover a portion of the period prior to the taxpayer's floor stocks tax return." (Brief for Appellee, p. 15.)

This statement is in error for two reasons: First, the taxpayer sold his business on May 25, 1944, so that the audit covered a period of only ten months and twenty-five days. Second, that audit made a determination of distilled spirits sales for the period June 1, 1943 to March 31, 1944. As set forth in brief for appellant (pp. 22-23), the gross sales exclusive of sales tax as reflected by appellant's books between July 1, 1943 and March 31, 1944 were $207,473.58 and

the distilled spirit sales, exclusive of sales tax, for the same period were $200,025.68. Dividing $207,-473.58 by $200,025.68 results in 96.41%.

III. "The quantities of distilled spirits sold each month increased and therefore the percentage of distilled spirits sold in relation to total sales from July 1, 1943, to June 30, 1944, would have been greater than during the period from November 1, 1942 to March 31, 1944." (Brief for Appellee, p. 15.)

Appellee in his desire to grasp for straws in the wind even resorts to *ignoring a written stipulation between counsel* in this case. This stipulation is binding. (Tr. 26 to 29.) This stipulation effectively means that if *96.41* per cent of the total sales between July 1, 1943 and March 31, 1944 were distilled spirits sales, *then the entire assessment here in question is in error* and *the inventory* of appellant as of April 1, 1944, upon which the return was based, *is accurate,* as analyzed in brief for appellant (pp. 24-27). Appellee is silent on this stipulation.

IV. "Accountant Bruck testified that the 96.41 percentage figure was based upon a figure which included sales tax." (Brief for Appellee, p. 15.)

Counsel for appellee has overlooked the simple arithmetic principle that if the distilled spirits sales *including* sales tax were 96.41 per cent of the total sales including sales tax, then it follows as surely as night follows day that the distilled spirits sales, *exclusive* of sales tax, are still 96.41 per cent of the total sales exclusive of sales tax because all the sales

tax does is increase each figure proportionately, to-wit, by 2½%.

V. "The figure used was $91,767.40, total sales for the first three months of 1944 (Tr. 193). The sales from January 1 to March 31, 1944 amounted to $36,-510.93 as shown by the daily sales records. * * *" (Brief for Appellee, pp. 15-16.)

Please note the words "as shown by *the daily sales records.*" This is a misstatement, and an attempt to mislead by omission. Appellee could not substitute for the above quoted phrase: "as shown by *the permanent records.*"

The $91,767.40 represents *total sales* for the first three months of 1944 and was obtained from the appellant's *permanent records.* (Tr. p. 189; Exhibit 14, Section marked "Expense", fourth page from end of section.) In addition to the permanent record, a temporary record was kept by the clerks. (Tr. p. 136.) This was not a part of appellant's permanent records and did not include large case sales (Tr. p. 137), hence, did not include all sales. Mr. Bruck, C.P.A., testified that Exhibit 18 was *a purely temporary record* and that the permanent records of the appellant were Plaintiff's Exhibits 14 and 17. (R. 181 and 205.)

VI. "Bruck testified that without the daily record the sales of distilled spirits could not be determined (R. 191)" (p. 16, Brief for Appellee).

Bruck did not so testify. The citation referred to by appellee is with reference to the "details" of some

$62,946.84 in sales. (Tr. 191.) No permanent record contains detailed sales. Does appellee contend that a permanent bookkeeping record must separately list each individual sale?

Mr. Bruck testified appellant kept a double entry set of books which were complete and properly kept; that he could determine appellant's purchases, sales and inventory as of a given period from these records. (TR. p. 165.) *The sales could be determined from the permanent records in evidence and appellee's attempt to discredit this fact is abortive unless he does so from permanent records as distinguished from temporary records.*

Appellee does not contend that the permanent records of appellant do not reflect the total sales for each and every day. There is no requirement of law, accounting principles, or business purpose that would be served by the maintenance of a record of the type suggested by appellee. And appellee has offered no proof of the requirement of such records.

Thus an analysis of the six objections of appellee to the adoption of the 96% figure, discloses not only that they are groundless, but their very weakness only strengthens the unanswered arguments of appellant for the adoption of this figure.

This Court in the case of *J. M. Perry v. Commissioner* (C.C.A.-9) (120 F.(2)123) stated on page 124 with regard to findings of the Bureau of Internal Revenue:

> "This finding is presumptively correct, that is, until the taxpayer proceeds with competent and

relevant evidence to support his position, the determination of the Commissioner stands. When such evidence has been adduced the issue depends wholly upon the evidence so adduced and the evidence to be adduced by the Commissioner. The Commissioner cannot rely upon his determination as evidence of its correctness either directly or as affecting the burden of proof. Welch v. Helvering, 290 U.S. 111, 115, 54 S. Ct. 8, 78 L. Ed. 212, Helvering v. National Grocery Co., 304 U.S. 282, 294, 295, 58 S. Ct. 932, 82 L. Ed. 1346; Helvering v. Talbott's Estate, 4 Cir., 1940, 116 F.(2d) 160, 162".

This Court reiterated this rule in *San Joaquin Brick Co. v. Commissioner,* 130 F.(2) 220, and *Hemphill Schools, Inc. v. Commissioner,* 137 F.(2) 961.

Appellant has presented overwhelming evidence to support the 96.41 per cent figure. Appellee offers no factual support of the 86% figure. He urges its acceptance with the arbitrary contention that since it was appellant's estimate he cannot complain if it was used. We can only conclude that 96.41% is the correct percentage of distilled spirits sold from July 1, 1943 to March 31, 1944 and therefore the primary assessment is erroneous and illegal. If the primary assessment is baseless, it follows that the fraud penalty is necessarily in error.

APPELLANT AGREES THAT THE BEST EVIDENCE TO SUSTAIN TAXPAYER'S TAX RETURN IS HIS BOOKS.

Appellee in his brief (p. 16) states:

"The best evidence to sustain taxpayer's floor stocks tax return was his books."

Appellee himself relied on those books and from them obtained the distilled spirits purchases and the gross sales used in his formula. (Tr. pp. 264, 265.) The State Board took its figures from these same books to arrive at the 96.41% figure. Mr. Bruck testified that these records were complete and properly kept, and that from them he could determine the appellant's purchases, sales and inventory as of a given period. (Tr. p. 165.)

Appellee claims the books are incomplete on the basis of Mr. Hedrick's opinion. Mr. Hedrick's "opinion" was treated fully at p. 17, Brief for Appellant. Thus we have the situation where appellee states a rule that the best evidence to sustain the return is the taxpayer's books, and then refuses to abide by an audit of those very books, or to audit them himself.

Furthermore, in the report of the State auditor (Tr. p. 19), we find a specific statement that the records were such as were required by law from which could be determined the percentage of distilled spirits sales.

Appellee's statement that appellant did not produce his books for 1943 is an error, either calculated or mistaken—but an error nevertheless. The permanent records of appellant for the entire period were in

evidence. (Tr. pp. 181, 205.) It was only a part of Ex. 18, a temporary record, which was missing. The daily sales records were incomplete in that they contained only non-case sales. As appellee himself states, these records showed only $36,000 of the $91,767.40 sales during the first three months of 1944. When appellee, himself, sought the sales figures for his formula, he took them *not from the daily sales* records but *from the permanent* records. (R. 265.)

Certainly, counsel for appellee must have had his tongue in his cheek when he wrote:

"The taxpayer has failed to produce any evidence to show the extent to which the Commissioner's assessment is wrong. * * *" (Brief for Appellee, p. 17.)

We have a concession in the use of the word "extent". The "extent" is the difference between 86% and 96.41% or 10.41% of the gross sales which by stipulation of counsel (pp. 26-29) wipes out the primary assessment. The appellee has ably adopted a classical application of the maxim, "If you can't convince 'em, confuse 'em."

APPELLEE HAS NOT SUSTAINED HIS BURDEN OF PROVING FRAUD BY CLEAR AND CONVINCING EVIDENCE.

Appellee presents five contentions re the fraud penalty.

I. Truck movements on March 31, 1944 (Brief for Appellee, pp. 9-10).

Appellant covered this fully in his opening brief. (Brief for Appellant, pp. 28-30; p. 43.) Any "suspicions" that might have been aroused by the truck movements are eliminated by the fact that the 96.41 figure should have been used in the formula.

The appellee finds himself in the position of contending that the so-called truck movements confirm the erroneously calculated understatement and the erroneous understatement confirms his suspicions with regard to the truck movements. Appellee argues that suspicions plus estimates are better evidence than accepted records and audits.

Not once did appellee's agents ask appellant for an explanation of this alleged movement of goods. When the fraud penalty was assessed, *no reference was made* to said truck movements, but said penalty was based purely on the amount of the computed deficiency arrived at by the use of the estimated *86% figure*. (Schedule II, Appendix B, Brief for Appellant.)

Appellee's answer made no reference to concealment of whiskey but alleged that the underdeclaration was caused "by errors and omission in the records kept by the plaintiff at his place of business". (Defendant's Answer, Par. VI, Tr. p. 20.)

II. Sales of March 30 and 31, 1944 by appellant do not account for 400 cases of whiskey withdrawn from the warehouse on March 30 and 31, 1944. (Brief for Appellee, pp. 10, 13, 14, 17, 22.)

Appellee contends that appellant's records do not account for the sale of the 400 cases of Three Rivers drawn from the warehouse on March 30 and 31, 1944, because the sales on those days were $2,433.06 and $2,663.90, respectively, and based on a selling price of $33.00 to $40.00 a case, if 400 cases were sold the sales would have been between $6,600 and $8,000 on each of those days. Appellee completely *ignores* the fact that *the appellant declared 271⅓ cases of Three Rivers whiskey;* thus, the sales for the two days *did not have to account* for 400 cases of whiskey, but rather, for the sale of 129 cases. One hundred twenty-nine cases sold for $33 to $40 per case would bring $4,200 to $5,100 for the two days in question ($2,433.06 plus $2,663.90 is $5,096.96). Thus appellant fully accounted for the 400 cases in the 271⅓ cases reported on hand on March 31, 1944, and the sales on March 30 and 31, 1944.

Since plaintiff's Exhibit 2, the recap of the Geary Store inventory, discloses that Three Rivers whiskey was the only whiskey in the store, it represented the sole source of sales income.

It is an open and notoriously known fact that in March of 1944, whiskey supplies were scarce. The sale of the Three Rivers withdrawn prior to March 30, 1944 are accounted for in the sales for February and March. Appellee examined every purchase invoice at the source of supply and was fully aware of the fact that appellant had received no other brands of whiskey in amounts sufficient to account for his sales.

Yet appellant states, on page 11 of his brief: "It is a reasonable assumption under the evidence that the Three Rivers whiskey reported in taxpayer's tax return was that remaining from withdrawals made from the warehouse before March 30th, 1944." No citation from the record is given in support of this "assumption", and there is no such evidence.

III. Appellant did not know how many cases of Three Rivers whiskey were on hand, on the opening of business on March 30 and 31, 1944 (Brief for Appellee, p. 11).

Appellee takes appellant to task because he could not testify to the number of cases of Three Rivers on hand *at the opening of business* on March 30 and 31, 1944.

No law required appellant to have this knowledge. Appellant was not active in the operation of this store. He had two other stores he owned and operated. The law required that appellant take an inventory as of the *close* of business on March 31, and not at the beginning of business on March 30 or 31.

IV. Appellant reported 100 cases of Three Rivers whiskey which appellant testified were at the Haight Street store but appellee denies the said 100 cases were at said store (Brief for Appellee, p. 11).

As is set forth in appellee's brief (p. 11), appellant reported 271⅓ cases of Three Rivers whiskey, 100 of which cases appellant testified were in the Haight Street store basement on April 1, 1944. Appellee's

witness, Hedrick, denied this. Appellant demonstrated conclusively that Hedrick was put on notice of merchandise stored elsewhere. (Brief for Appellant, pp. 30-34.) The only question was the location of said 100 cases for it *was granted that appellant reported them.* Appellant also pointed out that Hedrick admitted that he never went into the basement. (Brief for Appellant, p. 258.)

V. Appellant failed to report 100 cases of Three Rivers whiskey which appellee claims were at the Haight Street store (Brief for Appellee, p. 13).

As above pointed out, appellee *denied* there were 100 cases of Three Rivers at Haight Street store (Brief for Appellee, p. 11.)

Now to sustain his assessment he argues that *there were* 100 cases of Three Rivers at Haight Street but they were not reported.

Appellant detailed the respective inventories of the Haight and Geary stores and the actual entries therein which established conclusively that the 100 cases at the Haight store were reported. (Brief for Appellant, pp. 30-34.) Appellee has, as he has done throughout his argument, kept a hands off attitude of the appellant's records and inventories. Not one word is contained in appellee's brief respecting the inventories above mentioned.

The trial Court found that *appellee's* inventory of May 2, 1944 did not include the said 100 cases at the Haight Street store. Hence an overstatement re-

sulted. Since 40 of the 100 cases had been removed before May 2, the remaining 60 cases wiped out the alleged 108 proof gallon overdeclaration. (Tr. pp. 91, 179.)

APPELLEE ADMITS HIS CASE IS BASED ON GROUNDLESS SUSPICIONS AND UNWARRANTED ASSUMPTIONS.

Appellee effectively admits the weakness of his case on page 14 of his brief, wherein he challenges appellant's statement that appellee's evidence is unproved suspicion, with,

"Surely it will not be said that the withdrawal of 400 cases of whiskey from the warehouse on March 30 and 31, 1944, and the fact that taxpayer's records for those days failed to show sales of such quantities was immaterial. This evidence goes to the very heart of the case."

As we set forth above, the appellant declared 271⅓ cases on March 31, 1944, and his records could not therefore show sales of 400 cases but rather the sale of some 129 cases.

No better example of the weakness of appellee's position can be shown than that of appellee's argument on page 17 of his brief. After a series of assumptions and conclusions, unsupported by record citations, appellee's attempt to account for the shortage of 600 cases utterly fails. (R. 17.) He finally reaches an alleged shortage of 500 cases, but the

method adopted is as arbitrary and baseless as is the primary assessment.

Appellee assumes that none of the 400 cases were sold. There is no evidence to support this assumption. Appellee next *assumes* that the 100 cases at Haight Street were not reported. Hence he arrives at a 500-case shortage.

He ignores entirely the fact that 129 of the 400 cases were sold on March 30 and 31, 1944. He ignores the fact that appellant reported 271⅓ cases on hand on April 1, 1944. He ignores entirely the fact that the 100 cases at Haight Street were reported and also that this 100 cases was part of the 400 cases.

As appellant stated in his brief, only 775 cases of Three Rivers whiskey were ever purchased by appellant. (See, also, Brief for Appellee, p. 9.) Appellant reported 271⅓ cases leaving only 500 cases to be accounted for, even if none were sold. Appellee claims a shortage of 600 cases. Appellant sold Three Rivers during February and March, when whiskey was in tremendous demand due to the war shortages.

AN ASSESSMENT BASED ON AN ADMITTEDLY ERRONEOUS ESTIMATE IS NOT LAWFUL.

Appellee states that an assessment based upon an estimate is lawful. Appellee cites as authority *United States v. United States Fidelity & Guaranty Co.*, 144 Fed. 866, and *United States Fidelity & Guaranty Co. v. United States*, 220 Fed. 592. The *latter case* did

not involve any question of an assessment based on an estimate. In the former case there was no discussion of the law or of the facts other than the one sentence statement that an assessment based upon an estimate is lawful. While the use of estimates based upon facts in evidence is probably proper in some cases, *erroneous estimates contrary* to facts are no basis for an assessment.

APPELLEES HAVE NOT DISTINGUISHED CASES CITED BY APPELLANT ON ARBITRARY ASSESSMENTS FROM THE PRESENT CASE.

Appellee distinguished *Helvering v. Taylor,* 293 U.S. 507, on the theory that there was no presumption of correctness of the commissioner's determination as it was an appeal from the Tax Court. Of course this statement of law is incorrect as the same presumption of correctness applies in the Tax Court as in the District Court and the Supreme Court said in *Helvering v. Taylor,* on page 515:

> "Unquestionably the burden of proof is on the taxpayer to show that the commissioner's determination is invalid * * *"

Appellee distinguishes *McDonald v. Commissioner* (1944 P.H. T.C. Memo. Dec., par. 44,363) on the ground that in that case the Commissioner assumed a 10% profit without evidence whereas here the estimate was made by the taxpayer. This distinction is one without a difference. Does appellee contend that if the taxpayer in the *McDonald* case had made a

10% profit estimate he would have been bound by that estimate even though the records and other evidence showed that the estimate was wrong?

The same distinction is made with regard to *Harris v. Commissioner* (1948 P.H. T.C. Memo. Dec. par. 48,235) by the appellee. However, in that case, the taxpayer *did supply the estimate* that was erroneously used by the Commissioner. Also the Court pointed out that the taxpayer was charged with the possession of sums based on a formula when there was no evidence to show the actual possession of such sums. The similarity to the present case is precise.

Appellee distinguishes *Ward v. Commissioner* (1948 P.H. T.C. Memo. Dec., par. 48,133) and *Stratton v. Commissioner* (1949 P.H. T.C. Memo. Dec., par. 49,143) on the grounds that they hold that an assessment without foundation, excessive, and not consistent with surrounding circumstances is illegal. Our brief points out that the assessment in this case is also without foundation, excessive, and contrary to the facts. The cases are therefore in point.

APPELLEE'S CONTENTION THAT APPELLANT WOULD NOT DRAW WHISKEY FROM WAREHOUSE EXCEPT TO DEFRAUD GOVERNMENT IS ERRONEOUS.

Appellee concludes that the taxpayer would not have drawn whiskey from the warehouse except to avoid declaring it in his return and thus this proves intent to defraud. (Brief for Appellee, p. 22.) Appellee further states that appellant has not accounted

for said merchandise. As we previously set forth, the inventories and the sales accounted for said 400 cases in full.

Appellee contends that there was no room in the store for the merchandise. This is contrary to the evidence. Appellant's testimony was that 100 cases were stored at the Haight Street store because of lack of space at Geary Street but the other 300 went to the Geary Street store. (Tr. pp. 78, 79, 80.) Appellee introduced no evidence on this point.

We feel that this Court can take judicial notice of the fact that when consumers are aware that a commodity will rise in price due to a new excise tax, they will purchase larger quantities than normally—prior to the effective date of the tax. This is reflected in appellant's sales in excess of $5,000 on March 30 and 31, 1944. Thus appellant's reason for removing liquor from the warehouse was based on a sound business purpose.

CONCLUSION.

The brief for appellee does not present one well-founded objection to the appellant's undisputed evidence that 96.41% of the sales between July 1, 1943 and March 31, 1944 were distilled spirit sales. Not one well-founded argument is offered by appellee to support the 86% figure. Therefore the 96.41% figure must be accepted as proper as a matter of law, and thus the entire primary assessment is in error.

There can be no fraud penalty if there is no underdeclaration. The argument and testimony of appellee with regard to alleged fraud is based on pure speculation and suspicion, and is groundless. Appellee has failed to offer any evidence to support the fraud penalty, therefore he has failed to meet his burden of proving fraud by clear and convincing evidence.

Dated, San Francisco, California,
October 13, 1950.

Respectfully submitted,
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